

\$40.00 ANNUALLY
40 Letters Per Year

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

Registered with the Securities and Exchange Commission

Copyright 1959 - Richard Russell

July 24, 1959

Number 73

Page 1

QUESTION. "What do you think of short selling? I notice that you seldom mention it."

ANSWER. Short selling is a tricky business; short selling within a primary bull market is doubly tricky and should only be attempted by speculators who know exactly what they are doing and are aware of the risks involved. In general, short selling is less satisfactory than buying, and the reasons are as follows: (1) the short seller is always speculating; sooner or later he must cover, whereas the buyer, theoretically, may hold his stock forever; (2) dividends are paid out on short sales, but the buyer collects the dividends; (3) there are no capital gains for the short seller; he can hold his shorts forever, and Uncle Sam still considers his profits as taxable income; (4) there are certain psychological problems connected with shorting the market, and these are by no means easy to overcome.

Many people are of the opinion that there is something immoral or destructive in speculating for the decline. As far as I can see, however, it is no more immoral to sell stock at current prices with a promise of future delivery than it is to buy stock at current prices with the hope of future profitable sales. Some investors feel guilty about opening the morning papers and searching eagerly for news of a market collapse. They are far happier when they are attuned to human nature, which tends to be positive, optimistic, and bullish. Along these lines, one of the finest discourses on shorting appeared in Fred Schwed, Jr.'s book, "Where Are The Customers' Yachts?"

"Occasionally a customer is persuaded to try his hand at it (shorting). Immediately after he makes his sale he becomes acutely wretched and he stays that way until he has covered, whether at a profit or a loss. For some subtle reason, the idea that he owes someone stock he hasn't got is insupportable. What he is accustomed to, quite as a matter of course, is owing someone some money he hasn't got. In comparison, this condition scarcely worries him at all. When he buys a stock, borrowing money casually from the broker to do it, and the stock goes down five points he is comparatively calm. But when he sells it short and it goes up $3/4$, he is immediately desperate. He thinks it might go to 1000, although precious few stocks ever have. When he buys he never considers that it might go to zero, though that is the precise figure where many common stocks eventually wind up."

Personally, I prefer not to speculate against the primary trend of the market. When the primary trend is up, the tide is running against the short seller. He may short the market during an extended rise, hoping for a correction, and he may be fortunate enough to catch the ensuing decline. But he can never be sure whether the decline will carry far enough to be profitable or whether his particular stock will decline with the market. The most successful bull market shorting that I have seen has occurred (1) in connection with individual stock charting where a stock breaks down through an important support level (as the aircrafts have been doing), (2) where both averages penetrate previous low points on high volume and weaker issues are shorted.

In both cases, of course, it is assumed that short sales can actually be executed. This is not as easy as it sounds. The S.E.C. has severely handicapped the short seller by

requiring him to put out his shorts only on up-ticks, i.e., higher quotes. For instance, the following quotes appear on the tape: 60 1/8, 60, 60 1/8, 60 1/8, 60 1/4, 60 1/8, 60. The second 60 1/8 may be shorted (it is an up-tick), the third 60 1/8 can be shorted (the price of 60 1/8 still represents an up-tick, and shorts can be put out at this price as long as the price holds), the 60 1/4 can be shorted (it is another up-tick), but the last 60 1/8 and 60 cannot be shorted; they are both down-ticks. In other words, the short seller is required to sell on market strength, which is a psychological and financial handicap.

The best place for shorting is during a rally after it has been established that the primary trend is down (a bear market). Here time works for the short seller (not against him as in a bull market), and the long range trend is to lower prices. A rally in a bear market often ends in a period of dullness, and it is in this dull area that shorts should be put out. Remember, the tendency of volume is to diminish during bear market rallies (as well as during bull market declines). Therefore, a period of dullness, following a bear market rally, is usually a prelude to a further decline on increased volume.

For the reasons outlined above, I have not advocated any short selling during this bull market. I will suggest shorting when we can definitely establish that the primary trend has turned down. At the top of the first rally following the bear signal, shorts will be suggested. At that time the great primary trend, like the tide of the ocean, will be on the side of the bears.

QUESTION. "You have stated that the primary swing which began in October, 1957, has not yet been corrected by a secondary reaction. Would you please explain."

ANSWER. Rhea defined a secondary reaction in a bull market as "...a decline usually lasting 3 weeks to as many months, during which time the market retraces 1/3 to 2/3 of the preceding primary movement which has occurred since the end of the previous secondary reaction (or the end of the preceding bear market)."

Yet Rhea was never dogmatic about his definitions. He classified one retracement of only 7 days (in 1902) as a secondary because the move had fully corrected the previous primary advance, and volume had picked up as prices declined, ending in a selling climax -- all typical of a true secondary reaction. In another case (1921) he called a decline of only 16% in industrials a secondary. This was because rails had dropped considerably more, and because the sell-off had fully corrected the previous shallow primary advance. Rhea always considered the character of the preceding market action as well as volume indications during selling in determining whether a movement was entitled to a secondary designation or not.

In reviewing the price movements over the current 21 month primary advance, I can find no formation which, in my opinion, fits into even the most liberal definition of a secondary reaction. At the present stage of the swing, a retracement of perhaps 25% or 60 points in industrials over a period of a few weeks or so might pass as a very mild secondary, but there has been no sell-off which has even begun to approach these figures. Most true secondaries end with a volume climax (relatively high volume at the bottom), but almost every decline since October '57 has ended on dull volume. We have witnessed a few sharp 10% corrections on comparatively high volume, but these have been in the nature of semi-panic declines and have lasted only 3 or 4 days. Here, too, the character of the selling was so sudden and short-lived that a secondary designation was impossible. Almost all secondaries are composed of two or more downward zig-zags, and this also would exclude most of the declines of recent months from qualifying as secondaries.

LAW OF THE MARKET. Readers have been urged repeatedly to ignore the bullish or bearish pronouncements of the experts as far as the timing of purchases and sales is concerned. As late as Letter 70 I stated, "Investors who have missed the entire swing

since the '57 lows will still do better if they make their purchases on the implications of the averages rather than on the basis of friendly 'tips' or optimistic newspaper articles".

The explosive rally which began at our "buy-spot" (pt. Z - see chart) took both averages to new highs (rails to their highs since 1956). Letter 71 and 72 called attention to that law of the market which says that every movement of the averages is entitled to a 1/3 to 2/3 correction, and I went on to say that the Z-A rally would also be subject to the normal retracement. Readers who bought at the top of the advance at pt. A, rather than at the buy-spot at Z, received a lesson in market action and reaction. The A-B decline erased 22% from the industrial average and 65% from the rails. Those who bought at the highs may blame the steel strike: they may even point an accusing finger at the "bears". The market, nevertheless, corrected the Z-A advance in the same manner that it corrected advances back in 1902 when Charles Dow first put forth his timeless observations concerning the movements of stocks and the market.

CURRENT PRICE-MOVEMENTS. It was pointed out (Letter 72, July 17th) that volume was tending to diminish on the decline from the A highs. Because of this absence of selling pressure I wrote, "From whatever decline lows are now being established, an attack on the A highs may be expected." Subsequent to Letter 72, volume dried up completely on the downside, and at the decline lows (B - see chart) volume dropped to 2 1/2 million shares for two successive days.

On July 21 the expected rally began as industrials and rails advanced 6.94 and 1.25 points respectively. Volume on that day increased to 3 million shares. The next day (July 22) saw the industrial average better its A pt. and go to a new all-time high as volume increased again. July 23 was "resting day" as both averages budged upward, then backed off on duller volume. Rails, having lost 2/3 of their recent advance (Z-A) have, nevertheless, been moving "in gear" (in the same direction) with industrials. Yet the carrier average has shown an inclination to decline more rapidly and advance more sluggishly than industrials. For this reason the rail average bears close watching, and any signs of near-by danger will be probably tipped off by an "out-of-gear" movement in the carrier index.

The secondary trend will be reaffirmed as bullish if and when the rails better their last high at A (173.56). A persistent refusal of the rail index to better its A high should be regarded with suspicion, but as long as rails continue to move in the same direction as industrials the Dow Theory places no arbitrary time limit on confirmation. Prior to a rail confirmation, if both averages turn down and violate the B lows (industrials 654.54, rails 165.75) on increasing volume it would strongly suggest that the secondary trend was in the process of turning down. In this case traders who made purchases at the recent "buy-spot" (Z) could protect themselves by taking profits.

STOCKS. The difficulty in capturing profits is increasing as time goes on. About half the stocks on the big board are looking tired, and many are performing quite erratically. For instance, W. R. Grace, recently recommended, broke out for a new high, (moved up 4 points) then backed and filled as it lost its momentum. United Airlines acted the same way. On the other hand Heyden-Newport and Morrell (also recommended) have acted well. My own opinion is that there is now quite a bit of profit taking on the break-outs whereas a year ago when a stock broke through an important resistance area it acted like a Roman Candle. Bucyrus Erie was recommended at about 33, it moved to 35 5/8, then promptly went into a reversal formation. If it closed below 28 1/2 I would take the loss, otherwise hold on. The entire capital goods group, in fact, has recently acted the way the airlines did a few months ago. They looked beautiful, many advanced to new highs for the year. Since they have reacted and held within a narrow range. It is possible that they are discounting the adverse affects of higher interest rates on the building and construction trades.

I have put stop losses under some stocks, and I am willing to get stopped out. I have sold some others as they went into new high ground, just to get used to the idea of cash. When the whole country embarks on a flight from cash and amateurs offer to tell me how to make money in stocks, I tend to harbor a growing affection for "greenbacks".

Pan American World Airways has formed a great "toppy" looking structure and it should be sold if it closes below 27. Would sell International Tel. & Tel. if it closed below 36. Chrysler (recently recommended) is consolidating and seems to be trying to get through its 72 5/8 high. I like Rheem Mfg. for purchases here. Hercules Powder, recommended at 62, seems right for profit taking. Volume on this stock has fallen off on the recent advance. I would sell Flintkote at the market. Thiokol should be sold on any closing below 50.

(Written July 23, after the close)

